87-SBE-054

BEFORE THE STATE BOARD OF 'EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
) No. 84A-39-AJ
DAVID W. AND CAROLE ECHT) 84R-511

For Appellants: Steven K. Ridgeway
Certified Public Accountant

For Respondent: David Lew
Counsel

O P I N I O N

These appeals are made pursuant to section 18593[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of David W. and Carole Echt against a proposed assessment of additional personal income tax in the amount of $8,562 for the year 1980, and pursuant to Section 19057, subdivision (a), of the Revenue and Taxation Code from the action of the Franchise Tax Board on the claim of David W. and Carole Echt for refund of personal income tax in the amount of $3,805 for the year 1981.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the years in issue.

The first issue presented for decision is whether the special allocation of partnership losses contained in the E & B Enterprises partnership agreement is valid for tax purposes. The second issue is whether a loan commitment fee incurred in 1980 is fully deductible in that year.

In 1980, appellants and one Eric Bruckner formed a partnership known as E & B Enterprises, with the purpose of constructing and managing commercial real estate property. Appellants made an initial capital contribution of $270,000 while Mr. Bruckner made an initial contribution of $12,000. The partnership agreement specified that appellants and Mr. Bruckner would each hold a 50 percent interest in the partnership but allocated all partnership losses to the partner who at the time had the larger capital account. Losses were to be allocated equally once the capital accounts were equalized. The agreement provided that cash arising from the sale of partnership assets would be distributed first according to the capital accounts and then equally. However, the agreement provided further that upon liquidation any cash available for distribution to the partners would be distributed equally. Respondent determined that the special allocation did not have substantial economic effect, and thus, could not be given effect for tax purposes.

The second issue involves a Loan Commitment Agreement ("Loan Agreement") with EBCO, a corporation apparently owned by Mr. Bruckner. In consideration for the payment of $81,000, EBCO agreed to loan the partnership $810,000. The Loan Agreement provided that EBCO's obligations would automatically terminate fifteen days from substantial completion of the building, or, in any event on, March 31, 1983. Appellants explain that this commitment was a standby commitment to be used only if financing on more favorable terms could not be obtained. The commitment was not used. The partnership deducted the $81,000 paid for the commitment in 1980, the year in which it was paid. Respondent determined that the commitment fee should have been amortized over the term of the loan.

Respondent adjusted appellants' reported income in accordance with its determinations. It issued a proposed assessment for 1980 and informed appellants that they were entitled to a refund for 1981. It affirmed the proposed assessment after considering appellants' pro-

test, and these appeals followed.[2/] Appellants purportedly appealed for both 1980 and 1981. However; this board has no jurisdiction over 1981, since no proposed assessment was issued and no claim for refund was either filed or denied.

Section 17852 of the Revenue and Taxation Code provided that, in determining his income, each partner must account for his distributive share of partnership gain or loss. A partner's distributive share of gain or loss is generally determined by the partnership agreement. (Rev. & Tax. Code, § 17855.) An exception is made if the agreement makes an allocation to a partner which does not have "substantial economic effect": in that case, the partner's distributive share is determined in accordance with the partner's interest in the partnership. (Rev. & Tax. Code, § 17856.) Section 17856 of the Revenue and Taxation Code was substantially similar to section 704 of the Internal Revenue Code. Therefore, interpretations of the federal statute are relevant to the proper interpretation of the state statute.

A special allocation' has economic effect if it meets three requirements: (1) The partners' capital accounts must be maintained in accordance with certain rules; (2) upon liquidation of the partnership, distributions must be made in accordance with the partners' positive capital accounts: and (3) any partner with a negative capital account must be required to restore the amount of such deficit to the partnership. (Treas. Reg. § 1.704-1(b)(2).) Respondent's disallowance of the loss allocated to appellants by the partnership agreement was based on its determination that the second of the above requirements was not met, since the agreement did not state that, upon liquidation of-the partnership, profits would be distributed first in

2/ Upon determining that the loan commitment fee should not have been deducted in 1980, respondent disallowed the deduction taken that year to the extent of $77,841. Upon subsequent review, respondent determined that appellants had claimed a total of only $70,000 of the $81,000 loan commitment fee as a deduction on their return. The remaining $11,000 had been allocated to Bruckner. Stated otherwise, $7,841 was erroneously disallowed in calculating appellants' proposed assessment for 1980. Respondent concedes that a modification to the 1980 assessment is required.

accordance with the partners' capital account and then equally.

Appellants point out that the partnership agreement is inconsistent, since paragraph 6.3.2 provides that, upon sale of the partnership assets, distributable cash would be divided first according to the partners' capital accounts and then equally, but paragraph 9.2.4 provides that upon liquidation, cash would be distributed equally. Appellants contend that paragraph 9.2.4 contains a drafting error. The parties actually intended that any profit, whether upon sale of the assets or liquidation of the partnership, be divided according to the capital accounts. As support for this position, appellants have presented a Memorandum of Agreement entered into by the partners prior to the drafting of the formal partnership agreement. This memorandum states that cash arising from the sale of assets shall be divided according to the capital accounts, but makes no mention of distribution upon liquidation. This suggests that the parties did not agree to a different distribution upon liquidation. As further support, appellants presented a letter from the attorney who drafted the partnership agreement for Mr. Bruckner. The attorney states that, had the inconsistency in the agreement been noted, he would have revised the liquidation provision to correspond to the sale of assets provision. We believe that this evidence adequately establishes that the parties' agreement was to divide profits according to the capital accounts and that paragraph 9.2.4. was merely a drafting error. Therefore, we conclude that the agreement had sustantial economic effect and that the special allocation should be given effect.

The second issue is whether the commitment fee was, as appellants contend, properly deducted as an ordinary and necessary business expense under section 17202 of the Revenue and Taxation Code. We conclude that it was not. The sole authority cited by appellants is Rev. Rul. 56-136, 1956-1 C.B. 92, which held that commitment fees incurred pursuant to a bond sale agreement under which construction financing was to be available in certain amounts over a specified period are in the nature of carrying charges which may be deducted as business expenses. Although the ruling was revoked in 1981, (Rev. Rul. 81-160, 1981-1 C.B. 312), it would be applicable to appellants' situation at the federal level, since its revocation was prospective only. It does not follow, however, that this board is bound to apply Rev. Rul. 56-136 in this appeal. Revenue rulings are merely the

opinion of the Internal Revenue Service, and this board need not apply a ruling with which we disagree. (Cf. Appeal of Roy L. and Ilse M. Byrnes, Cal. St. Bd. Of Equal., June 28, 1979.) We believe that Rev. Rul. 81-160, supra, correctly analyzes the deductibility of standby loan commitment fees. It concludes that these fees are not deductible as expenses under Internal Revenue Code, section 162, since they are expenditures which result in the acquisition of a property right, the right to the use of money on specified terms, which has a useful life of more than one year. The ruling reasons that a standby loan commitment fee is similar to the cost of purchasing an option and concludes that it should be treated in the same manner as an option. Therefore, if the commitment is not exercised, the fee becomes an expense of acquiring the loan and must be amortized over the term of the loan. If the commitment .is not exercised, the ruling states that the fee may be deducted as a loss under section 165 of the Internal Revenue Code when the commitment expires. Since the partnership did not exercise the commitment, it may be entitled to deduct the commitment fee in the year EBCO's obligation under the Loan Agreement expired, that is, the earlier 'of 15 days after substantial completion of the project or March 31, 1983. 3/

For the reasons discussed above, respondent's action must be modified.

3/ We note that it may be necessary for appellants to file a claim for refund, since they may be entitled to the deduction in a year not before this board. If such a claim is barred by the appropriate statute of limitations, it appears that respondent should allow an offset of the barred overpayment in computing the deficiency in tax for 1980 or another year pursuant to section 19053.9 of the Revenue and Taxation Code.

Appeal of David W. and Carole Echt

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of David W. and Carole Echt against a proposed assessment of additional personal income tax in the amount of $8,562 for the year 1980, be and the same is hereby 'modified, and that the appeal from the action of the Franchise Tax Board on the claim of David W. and Carole Echt for refund of personal income tax in the amount of $3,805 for the year 1981 be and the same is hereby dismissed for want of jurisdiction. In all other respects, the action of the Franchise Tax Board is sustained..

Done at Sacramento, California, this 28th day of July, 1987, by the State Board of Equalization, with Board Members Mr. Collis, Mr. Bennett, Mr. Carpenter and Ms. Baker present.

Conway H. Collis, Chairman

William M. Bennett, Member

Paul Carpenter, Member

Anne Baker*, Member

, Member

*For Gray Davis, per Government Code section 7.9

87-SBE-054-A

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 84A-39 and
DAVID W. AND CAROLE ECHT"	)	84R-511-PD

ORDER DENYING PETITION FOR REHEARING

Upon consideration of the petition filed August 27, 1987, by David W. and Carole Echt for rehearing of their appeal from the action of the Franchise Tax Board, we are of the opinion that none of the grounds set forth in the petition constitute cause for the granting thereof and, accordingly, it is hereby denied and that our order of July 28, 1987, be and the same is hereby affirmed.

Done at Sacramento, California, this 17th day of November, 1987, by the State Board of Equalization, with Board Members Mr. Collis, Mr. Dronenburg, and Ms. Baker present.

Conway H. Collis, Chairman

Ernest J. Dronenburg, Jr., Member

Anne Baker*, Member

_____, Member

_____, Member

*For Gray Davis, per Government Code section 7.9